Analysis on the Go

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The Collapse of Silicon Valley Bank Explained

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Prologue

During COVID-19, central bank rates dropped to near zero. Add massive fiscal policy to aid an economy imperiled by the pandemic and the result is the cost of money settles to near zero while the supply of money surges. Two main beneficiaries of the excess liquidity in the system during the pandemic period were investments in innovative sectors, including technology, generally, and biotechnology, specifically.

What is Silicon Valley Bank?

Silicon Valley Bank (SVB) was touted as the enabler of the U.S. innovation economy. The bank has a 40-year history of catering to Silicon Valley startups as well as being the banker behind the Napa, California wine industry. The bank grew rapidly and was reportedly involved in banking 50% of all venture capital financings.

Why did SVB collapse, in particular?

Deposits surged at Silicon Valley Bank much faster than demand for loans. SVB invested the excess cash in longer-dated fixed income securities such as mortgage-backed securities and U.S. Treasuries to lock in a small coupon, or interest payment from the date of issuance until the date of maturity.

Then rates went up – dramatically – and those securities lost value. As rates went up, SVB's clients' fundraising efforts dried up and they began burning through deposits at an accelerated rate. In addition, some large venture capital funds called for their clients to pull deposits from the bank, which culminated in a crisis of confidence that created a classic run on the bank.

SVB was forced to sell those long-dated securities at a loss and reached a point where the bank was technically insolvent (i.e. unrealized losses exceeded bank capital). In other words, SVB dramatically underestimated the fluidity of their depositors and failed to manage interest rate risk on their balance sheet.

What about the role of regulators?

Unlike larger U.S. banks (with assets greater than US$250 billion), regulation for smaller/regional banks like SVB has not been as stringent in recent years. As a consequence, SVB was able to expose its balance sheet to sizeable interest rate risk, but regulators failed to monitor the bank's asset-liability mismatch.

What are the key details of the policy response to date?

On the evening of March 12, the Federal Deposit Insurance Corp. (FDIC) responded by guaranteeing all of Silicon Valley Bank's depositors and erected a new U.S. Federal Reserve facility called the Bank Term Funding Program (BTFP) that would allow all banks facing withdrawals to draw loans from the BTFP on a one-year term, using high-

quality debt securities, at par value, as collateral. The U.S. Treasury has backstopped this program with US$25 billion of capital.

While The Fed has already indicated it does not plan on drawing from this facility, the BTFP ensures the banking industry has adequate liquidity. The cost of the facility will be borne by other banks in the form of higher FDIC premiums in the future.

How concerned should investors be about other, even larger U.S. banks collapsing in similar fashion to SVB?

We believe the risk of collapse for larger U.S. banks to be much lower than smaller/mid-sized banks. The majority of U.S. banks had been planning for higher interest rates and post-COVID deposit draws for some time now. Most have diverse funding sources and are well-capitalized, stemming from measures put in place after the 2008 crisis. Meanwhile, unlike smaller, regional banks like SVB, the largest banks in the U.S. run robust risk management processes that get stress tested by the regulator every year.

What are the implications for the Fed's monetary policy going forward?

This incident also speaks to a broader issue related to the lack of cheap liquidity that exists for smaller banks in the financial system. As the Fed's quantitative tightening (or QT) program marches on, the cost of funding has become more expensive – especially for regional banks.

Further rate hikes may not help, since alternative vehicles such as money market funds are more attractive relative to deposits resulting in elevated funding costs. Given the obvious challenges with the regional bank system now at hand, investors should be prepared for tweaks to the Fed's QT program as well as its broader monetary policy to avoid any further tightening of financial conditions, while smaller banks need time to recover from these funding pressures.

However, the Fed may have its work cut out for it as the central bank balances its inflation fight against the impact of rate hikes on the regional banking system. The Fed has to balance near-term inflation pressures that, while gradually diminishing, remain above target against incoming deflationary forces resulting from the significant tightening in U.S. lending standards that we are witnessing. The recent market price action may be a preview of these incoming forces.

What could be the regulatory reaction going forward?

More banks will likely be held to the same global systemically important banks (or G-SIB) regulatory rules that currently govern the largest U.S. banks. This means regular capital stress testing and more "horizontal" stress testing, which probes for liquidity issues and duration mismatches like the one that brought down SVB. Horizontal stress tests also compel banks being tested to mark unrealized losses to capital levels and adjust accordingly, while holding additional buffers like total loss absorbing capital (TLAC).

Beyond that, FDIC insurance premiums should increase as well, and bank mergers and broader consolidation in the space should be expected in the coming years.

What is the impact on AGF Investors?

Generally speaking, AGF's equity strategies hold minimal to no exposure to U.S. regional banks. There has been some spillover to other financial subsectors (e.g., brokers, large money centre banks and Canadian banks), but the declines have been relatively modest. On the fixed income side, AGF's funds had generally lengthened duration in recent months, so they were in reasonable positions to capitalize on the recent turmoil as interest rates fell precipitously.

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